

## Georgia Joins Growing Number of States Adopting SALT Deduction Workaround for Pass-Through Businesses



### HB 149: Summary of Key Provisions

- S corporations and partnerships will be allowed to annually make an irrevocable election, on a timely filed applicable income tax return including extensions, to pay tax on their Georgia allocated or apportioned income at the entity level. The income will be subject to a 5.75% tax rate, and no deduction will be allowed for taxes based on gross or net income.
- Electing S corporations and partnerships will be subject to the estimated payment requirements that apply to C corporations.
- The income on which tax is paid by the electing S corporation or partnership will not be reported on the Georgia personal tax returns of the shareholders and partners and therefore will not be taxed at the shareholder/partner level.
- Resident shareholders and partners of electing S corporations and partnerships will also not be subject to Georgia income tax on income that is allocated or apportioned to other states.
- Nonresident shareholders and partners of electing S corporations and partnerships will not be subject to Georgia tax on the income allocated or apportioned to Georgia that will be subject to the entity-level tax. Also, the required withholding on distributions to nonresident members of partnerships, S corporations and LLCs will not apply to electing S corporations and partnerships.
- Electing S corporations and partnerships will be eligible to claim the following income tax credits: the Qualified Education Expense Credit, Qualified Rural Hospital Organization Expense Credit, and Qualified Education Donation Credit. For purposes of these credits the electing S corporation or partnership will be treated as an “other entity”, and therefore will be eligible to claim a credit of up to 75% of the entity’s Georgia tax liability.
- The election will not impact shareholder or partner tax basis except that their pro rata share of tax paid by the entity will be considered.
- An electing S corporation or partnership must be directly owned by persons eligible to be shareholders of an S corporation. Eligible S corporation shareholders include individuals (except for nonresident aliens), estates and certain trusts, and exclude corporations, partnerships and LLCs.
- This Act will be applicable to all taxable years beginning on or after January 1, 2022.

## Observations, courtesy of Bennett Thrasher Tax Department

- HB 149 represents Georgia's response to IRS Notice 2020-75, issued on November 9, 2020, which apparently endorsed workarounds that have been adopted by several states involving entity-level state income taxes on pass-through entities devised to avoid the \$10,000 SALT cap. Notice 2020-75 announced that Treasury and the IRS plan to issue proposed regulations that clarify that state and local income taxes imposed on and paid by partnerships and S corporations are not subject to the \$10,000 SALT cap for their partners or shareholders. The regulations will further confirm that the deduction for such income tax payments will be included in the partners' or shareholders' distributive share of non-separately stated income or loss for the tax year.
- Georgia follows the federal definition of a partnership, so for purposes of HB 149 a "partnership" can be a general partnership, limited liability company, limited liability partnership, or other form of legal entity that is treated as a partnership for federal income tax law.
- The fiscal notice on HB 149 from the Department of Audits and Accounts, dated February 15, 2021, assumes that the election can only be made by an S corporation or partnership that is 100 percent owned by natural persons. However, the text of the bill states that the election will only apply to an S corporation or partnership that is "100 percent owned and controlled by persons eligible to be shareholders of an S corporation under Section 1361 of the Internal Revenue Code", and under Section 1361 "persons" are not limited to natural persons. Eligibility may need to be clarified by the rules.
- Because an electing S corporation or partnership will be treated as an "other entity" for purposes of the Qualified Education Donation Credit, such entities will therefore be eligible to claim a credit of up to 75% of their Georgia tax liability. For federal tax purposes the payment for the credit will be fully deductible as an ordinary and necessary business expense under IRC Section 162, and therefore will reduce an owner's allocable share of "ordinary" income. **The shareholder or partner of an electing S corporation or partnership will therefore trade a nondeductible state tax payment (if they have already met the \$10,000 SALT cap) for an ordinary deduction which will reduce their federal tax liability to the extent of their marginal federal tax rate.**
- This legislation will therefore enable the owners of electing S corporations and partnerships to be in the same economic position (to the extent of the payment to Georgia PEACH) as the owners of pass-through entities where the pass-through entity currently makes the payment to Georgia PEACH or Georgia PEACH while claiming a business purpose for the payment. **However, the electing S corporation and partnership will not be required to claim any business purpose for the payment besides satisfying the entity's Georgia tax liability. This will significantly reduce the pass-through entity's potential exposure to claims that a payment to Georgia PEACH did not have sufficient business purpose and was not made in anticipation of receiving a financial return commensurate with the payment.**

- The other states that have adopted entity-level taxes on pass-through entities have included corresponding income tax credits for the S corporation shareholders and partners to offset their distributive share of income from the S corporation or partnership, to avoid that income being double-taxed. **In contrast, Georgia's workaround is unique in that an electing S corporation or partnership will essentially be treated as a C corporation for Georgia tax purposes for the period of the election.**
- For electing S corporations and partnerships that operate solely in Georgia and do not have nonresident owners, tax compliance will be relatively straightforward, and the only complicating factor will be that the owner will have a different tax basis for federal and Georgia tax purposes. However, that can already be the case due to other federal/Georgia differences anyway.
- Tax compliance will be somewhat more complicated for pass-through entities operating in multiple states and/or having nonresident owners. The C corporation treatment for Georgia purposes will apply only to income allocated or apportioned to Georgia. Georgia residents will not be subject to Georgia tax on income apportioned to other states from electing S corporations and partnerships, but presumably may still receive K-1s for other states from an electing S corporation or partnership and will be subject to nonresident income tax in those states.
- More significantly, nonresidents owners of electing S corporations and partnerships will not be personally subject to Georgia taxation and the nonresident withholding requirements will not apply to them. However, they will still be out of pocket for their share of the Georgia entity-level tax paid. If their resident state has an income tax and taxes world-wide income, to be made whole their own resident state will need to provide them with an offsetting credit. **This will likely make Georgia pass-through entities with nonresident owners (who reside in states with an income tax) reluctant to make the election until this uncertainty is resolved.** This issue is illustrated by the following example:

Assume individual N is a nonresident of Georgia and a resident of state B who is a partner of partnership P conducting business in Georgia and each year pays tax of \$1,000 to Georgia on N's distributive share of P's net taxable income. Also assume that N does not receive a federal deduction for the \$1,000 payment because N has already exceeded the \$10,000 SALT cap, but N does receive a full resident state tax credit of \$1,000 for the tax paid to Georgia. With the workaround under HB 149, P, rather than N, pays the \$1,000. The payment is fully deductible by P, and therefore N receives a federal tax benefit of \$370 assuming the highest marginal federal tax rate. N still bears the economic burden of the \$1,000 payment. However, because the payment is made by P, N does not personally pay nonresident tax to Georgia and therefore may not receive a resident state tax credit of \$1,000. If not, N is out-of-pocket in the amount of \$630 (i.e., \$370 federal tax benefit less \$1,000 lost resident state tax credit).